2. Comparative institutional analysis takes a long-run consumer welfare perspective. Video programming and distribution are dynamic markets for which we have dynamic goals. The development and diffusion of new services play an important role in market performance and should play an important role in its evaluation.

3. It considers the effects of regulation on market performance. This is particularly useful in the context in which the Commission is evaluating video markets. Specifically, the 1992 Cable Act places extensive and potentially costly regulatory restrictions on cable system operators and program suppliers because Congress decided both that video markets were not sufficiently competitive *and* that the regulations imposed would improve market performance and increase consumer welfare. Regulations can impose significant social welfare costs. The Commission should examine whether its regulations directed at cable operators and program suppliers are improving or reducing consumer welfare and whether deregulation or regulatory reform could improve market performance.

4. Comparative institutional analysis uses a balancing standard. This will assist the Commission (and Congress) to balance the imperfections of regulation against the imperfections of unregulated, or less regulated, video programming and distribution markets. The most important analytical framework that characterizes the transactions cost economics methodology is what Oliver Williamson calls a remediability standard:

> ...informed choice among alternative forms of organization entails trade-offs. Identifying and explicating trade-offs is the key to the study of comparative economic organization....
>
> Related to this last is the concept of remediability....references to benign government, costless regulation, omniscient courts, and the like are operationally irrelevant.[24]

This approach essentially asks what is the best that we can do given the economic and regulatory attributes that actually exist rather than focusing on what might be the best in a textbook world that does not exist in reality.

As an example of how the comparative institutional analysis might be applied, consider the effects of restrictions on programming exclusivity. Exclusivity provisions may be included in contracts between video programmers and distributors as a way to induce the distributors to invest in distributing and promoting new programming services. Exclusivity gives the distributor the possibility

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[24] Oliver E. Williamson, "Transaction Cost Economics and Organization Theory," *Industrial and Corporate Change* 2, 2, (1993): 107, 131. See also Joskow, " The Role of Transactions Cost Economics."

of gaining an uncertain return in the future if the programming service turns out to be successful. In the absence of exclusivity provisions, the distributor will invest less in new programming because its competitors will be able to capture the benefits of a successful programming service without incurring similar upfront investment costs. In response to regulatory restrictions, programmers and distributors will of course attempt to find alternative contractual or organizational arrangements to deal with this free rider problem. However, these alternatives may be more costly than straightforward exclusivity provisions, or viable alternatives may not exist, and investment in new programming will decline. Thus, if regulations governing exclusivity provisions are motivated by a perception that these provisions are a significant barrier to entry, the evaluation of market performance should be based on a consideration of both the benefit that may accrue from easier entry and the cost that may result from reductions in new programming.

II. MARKET DEFINITION

Market definition is a complex subject upon which much has been written.[25] It is not my intention to provide a comprehensive discussion of the issue here; rather, I want to point out several considerations relevant to the Commission's evaluation of competition and market performance in the video programming and distribution markets.

The traditional market definition process requires both a product and geographic market to be defined at the particular horizontal level of the production chain relevant to the issue under scrutiny. The markets of concern to the Commission involve suppliers at two or more horizontal levels of the vertical chain linking program production, intermediate packaging and distribution, and ultimate distribution to consumers. Product and geographic markets should be defined separately at each relevant horizontal level. The particular geographic definition is likely to differ from one level to another and may vary depending on the issue of concern.

For example, a wide array of program suppliers compete to get their programs carried, positioned and promoted by cable operators. These program suppliers include basic and pay services of various kinds as well as local stations and national broadcast networks. This competition takes place among programmers located throughout the country. Many of these suppliers use their programming to attract a national audience to sell to national advertisers. There is also indirect competition from national suppliers to other local distributors through their effects on the derived

[25] See U.S. Department of Justice and Federal Trade Commission, *Merger Guidelines*, (April 2, 1992) for an especially informative discussion of market definition.

demand for cable programming. These program suppliers typically deliver their services via satellite. As a result of all these characteristics, the relevant geographic market for video programming is likely to be national.

The geographic market for program distribution to final consumers is likely to be different. Consumers depend primarily on local broadcasters, local cable systems, other local multichannel distributors, video stores, movie theaters and direct to the home satellite distribution for their video programming. Consumers are unlikely to travel far to obtain such programming so that distributors must make the programming available to consumers either in their homes or nearby. From the consumer's perspective, the relevant geographic market for evaluating competition at the program distribution level is likely to be local.[26]

Despite this analysis, the appropriate geographic market for program distribution may not always be the same but may depend on the relevant issue. Different types of distributors sell their services over differently sized geographic areas. Cable operators may serve a particular town or group of contiguous towns; wireless cable and over-the-air broadcasters typically serve a wider metropolitan area; video dialtone service may cover a still wider area;[27] direct-to-home satellite distributors may offer the same service nationwide. In assessing the potential for entry and expansion by a noncable distributor, it may make sense to focus on its service area as a whole rather than the smaller local area relevant to a particular cable operator.

Product market definition is especially difficult in the case of differentiated products, such as video programming and distribution. Traditional product market definition implicitly assumes that we can identify, one way or another, a significant gap in the chain of substitutes that allows us to draw a meaningful bright line between what is in the market and what is out.[28] In differentiated product markets it may be very difficult to make this division, however, because such a clear gap in the chain of substitutes does not exist.

A sensible approach in these cases is to include all products that are reasonable but imperfect substitutes for one another in the relevant market. For example, it makes little sense to

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[26] In order to use this local geographic market to draw inferences about market power, all competing distributors that offer their services in the local area, even if their distribution facilities (e.g., satellites) are located elsewhere, should be included.

[27] In its Comments, GTE suggested that local markets be measured on a metropolitan statistical area or state level based on the service areas of local exchange carriers and wireless cable operators. *Comments of GTE*, p. 5.

[28] Richard Schmalensee, "Another Look at Market Power," *Harvard Law Review* 95, (1982): 1789-1816.

define a product market that encompasses only local multichannel distributors of video programming when over-the-air broadcasters and video rentals are important, albeit imperfect, substitutes. The omission of these substitutes is equivalent to an implicit assumption, contrary to fact, that these products place no significant competitive constraints on multichannel distributors.

At the same time, the inclusion of imperfect substitutes requires some adjustment. Otherwise, as in the case of simply calculating seller market shares for all products, imperfect substitutes are implicitly assumed to place the same competitive constraints as close substitutes. Instead, the analysis should take account directly of the degree of substitutability. In the case of multichannel distributors, over-the-air broadcasters and video rentals would be included in a way that effectively weighted the competitive constraints they place on multichannel distributors by taking direct account of the degree of substitutability between them.

New theoretical and empirical techniques have recently been developed that make this approach possible.[29] These promising techniques permit direct examination of the implications on market performance of entry, mergers or regulation. The Commission should explore how these techniques might be used to evaluate competition and market performance issues in video programming and distribution markets. They may make it possible to discard the traditional market definition-market share analytical framework which is likely to be poorly matched to the characteristics of the video programming marketplace in favor of a framework that better captures all of the margins on which competition takes place.

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[29] See, for example, Jerry A. Hausman, Gregory Leonard, and J. Douglas Zona, "A Proposed Method for Analyzing Competition Among Differentiated Products," *Antitrust Law Journal* 60, (1992): 889-900 and "Competitive Analysis with Differentiated Products," *Annales D'Economie et de Statistique* 34, (1994): 159-180; Hausman, "Valuation of New Goods Under Perfect and Imperfect Competition"; and Gregory Werden and Luke Froeb, "The Effects of Mergers in Differentiated Products Industries: Logit Demand and Merger Policy," *Journal of Law, Economics and Organization*, (1994 forthcoming).

CERTIFICATE OF SERVICE

I, Marla P. Spindel, hereby certify that on this 29th day of July, 1994, a true and correct copy of the foregoing "**REPLY COMMENTS OF HOME BOX OFFICE**" was sent via U.S. first-class mail, postage prepaid, or hand delivered, to the names on the attached list.

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